Material Loss Review
of
The First National Bank of Keystone

OIG-00-067 March 10, 2000

This report has been reviewed for public dissemination by the Office of Counsel to the Inspector General. Information requiring protection from public dissemination has been redacted from this report in accordance with the Freedom of Information Act, 5 U.S.C. section 552.

Office of Inspector General

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United States Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
March 10, 2000

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM FOR JOHN D. HAWKE JR., COMPTROLLER
OFFICE OF THE COMPTROLLER OF THE CURRENCY

FROM: Dennis S. Schindel Dennis Schindel
Assistant Inspector General for Audit

SUBJECT: Material Loss Review of The First National Bank of Keystone

This memorandum transmits the final report on our material loss review of The First National Bank of Keystone (Keystone). Our mandate under section 38(k) of the Federal Deposit Insurance Act (FDIA) required us to (1) ascertain why Keystone's problems resulted in a material loss to the insurance fund; (2) review the Office of the Comptroller of the Currency's supervision of the bank; and (3) make recommendations for preventing any such loss in the future.

This report covers the Office of the Comptroller of the Currency's (OCC) supervision of Keystone from 1992 until the bank's closing in 1999. OCC declared Keystone insolvent on September 1, 1999 after examiners could not verify $515 million in recorded loans. Alleged fraud is believed to be a factor in Keystone's failure, and Federal law enforcement agencies were still investigating the underlying circumstances at the time of this report. As of December 31, 1999, the FDIC estimated Keystone's failure will cost the insurance fund between $750 and $850 million.

From 1992 through 1999, OCC examinations repeatedly uncovered unsafe and unsound banking practices and regulatory violations. However, OCC enforcement actions proved largely ineffective in getting Keystone to fully address its operating problems. Alleged fraudulent accounting practices, uncooperative bank management and reported high profitability may have all served to mask the bank's true financial condition from OCC examiners. Despite this, indicators existed throughout the period that may have dictated a more aggressive supervisory response from OCC. The Office of Inspector General (OIG) believes that Keystone offers valuable lessons learned and opportunities for OCC to improve examinations and enforcement procedures.

The OIG makes seven recommendations. Three recommendations focus on different aspects of assessing the level of reliance that should be placed on audited financial statements when the accuracy of the information is in question. Three other recommendations are aimed at reassessing the enforcement response when bank management is either not timely or not compliant in addressing problems covered in an enforcement action. Finally, the OIG recommends that OCC evaluate whether a different supervisory approach is needed to address growth in high-risk activities, accompanied by high profitability and adequate capitalization, without sufficient management systems and controls.

In your March 8, 2000 written response to our draft report, you concurred with the reported findings and conclusions. In response to our recommendations, you indicated that you had recently formed a high level committee of senior deputy comptrollers to review how OCC can implement corrective action. A copy of your response has been incorporated in its entirety as an appendix to the report.

We appreciate the courtesies and cooperation provided to our staff during the review. Should you have any questions or require any further assistance, please call me at (202) 927-5400, or a member of your staff may contact Benny W. Lee, Director, Program Audits, in San Francisco, California at (415) 977-8810.

Attachment

cc: Laura L. McAuliffe, Director, Management Improvement

EXECUTIVE DIGEST

Overview

As mandated under section 38(k) of the Federal Deposit Insurance Act (FDIA), the Office of Inspector General (OIG) reviewed the failure of The First National Bank of Keystone (Keystone) in Keystone, West Virginia. On September 1, 1999, the Office of the Comptroller of the Currency (OCC) declared Keystone insolvent after examiners could not verify $515 million in recorded loans. Although alleged fraud is believed to be a factor in Keystone's failure, Federal law enforcement agencies were still investigating the underlying circumstances at the time of this report.

OCC examined Keystone yearly from 1992 until its failure in 1999. The examinations repeatedly uncovered unsafe and unsound banking practices and regulatory violations. However, OCC enforcement actions proved largely ineffective in getting Keystone to fully address its operating problems. Alleged fraudulent accounting practices, uncooperative bank management and reported high profitability may have all served to mask the bank's true financial condition from OCC examiners. Despite this, indicators existed throughout the period that may have dictated a more aggressive supervisory response from OCC. The OIG believes that Keystone offers valuable lessons learned and opportunities for OCC to improve examinations and enforcement procedures.

As of December 31, 1999, the FDIC estimated that the Keystone failure will cost the Bank Insurance Fund (BIF) between $750 and $850 million, making it one of the largest dollar losses in Federal Deposit Insurance Corporation (FDIC) history.

Objectives, Scope and Methodology

FDIA mandated review objectives include: (1) ascertaining why the bank's problems resulted in a material loss to the insurance fund, (2) reviewing OCC's supervision of the bank, and (3) as applicable, recommending measures to prevent future losses.

The OIG's review focused on OCC's supervision of Keystone from 1992 until the bank failed in 1999. We conducted fieldwork between September 1999 and January 2000.

The audit was performed in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States, and included such tests as were deemed necessary. During our review, Federal law enforcement officials were investigating potential fraud that may have led to Keystone's failure. As a result, we could not fully assess the cause of Keystone's failure. (See page 2)

Audit Results

Why Keystone Caused a Loss to the Fund

Keystone was a relatively small community bank situated in an economically depressed county in West Virginia. In 1977, with assets of $17 million, Keystone came under new management. Keystone's new management undertook an operating strategy that entailed growth into the high-risk areas of subprime mortgages, and selling loans for securitization. By 1999, assets had grown to $1.1 billion.

The majority of Keystone's loans were purchased or underwritten outside its local operating area, and included subprime Federal Housing Authority (FHA) Title I home improvement loans and similar high loan-to-value (HLTV) loans. The bank eventually pooled these loans for sale (i.e., securitization) by external underwriters. Rather than service the pooled loans themselves, Keystone used several commercial service providers throughout the country. Although viewed as risky, Keystone's strategy was reportedly profitable. Profitability aside, Keystone's growth in these high-risk areas occurred without adequate fundamental management systems and controls. (See page 1)

Keystone's insolvency was established during the 1999 examination when examiners were unable to verify the existence of $515 million of the $553 million in reported loans that were held by two of the commercial loan service providers. This discrepancy represented nearly 50 percent of the bank's reported assets in 1999. Inaccurate financial records masked Keystone's true financial condition. Furthermore, problems of weak financial accounting, reporting, and controls were repeatedly cited in prior OCC examinations. Allegations of fraud are presently under investigation. (See page 4)

OCC's Supervision of Keystone

<u>Bank Examination Results</u>
Beginning in early 1992, OCC conducted annual on-site examinations up to the time of Keystone's failure. These examinations were conducted under a

strained relationship with bank management marked by mutual distrust and an uncooperative bank management. Keystone management routinely contested examination findings. Also, examiners allegedly experienced delay tactics and were subjected to unusual working conditions such as being viewed by surveillance cameras and having phone conversations taped.

OCC examiners routinely identified unsafe and unsound practices, regulatory violations, and management activities that were questionable. OCC examination reports and supporting records were replete with indications that Keystone's financial accounting systems and reports were unreliable and the underlying controls were deficient. For example, OCC found ineffective internal and external audit functions in 1992 and 1993, apparent incidences of falsified bank documents in 1994 that resulted in criminal referrals, out-of-balance loan accounts between $8 and $12 million in 1995, and numerous other accounting and internal control problems.

Despite finding these significant problems over several years, OCC examiners generally did not perform more extensive examination procedures that might have revealed the true condition of the bank. For example, OCC examination procedures did not normally require loan verifications. OCC continued to rely on the results of the financial statement audits by external auditors that normally include tests to verify the existence of the loan portfolio. It was not until 1999 that OCC independently verified the reported loan balances at the commercial servicers. The OIG cannot conclude that earlier loan verifications would have surfaced the unsubstantiated loans sooner or minimized the loss to the Bank Insurance Fund (BIF). However, given the many problems identified year after year, earlier verification appeared warranted. (See page 6)

<u>Enforcement Actions</u>
In response to the numerous problems identified during examinations, OCC used both informal and formal enforcement actions, including the issuance of Civil Monetary Penalties (CMP). These actions proved largely ineffective in getting Keystone to fully address its operating problems, comply with provisions of the enforcement actions, or to cease violating banking regulations. Yet, correcting many of these problems would have been critical in addressing the bank's inaccurate financial records. The examiners ultimately found that these inaccurate records masked the bank's assets.

Aside from the possibility of fraud, it is unclear why OCC's enforcement actions were largely ineffective. However, the OIG believes some contributing factors were the timeliness and type of enforcement actions used. For example, OCC revised and extended a 1992 Commitment Letter giving Keystone nearly four years to comply. (See page 15)

Prior to terminating the Commitment Letter, examiners continued to find Call Report violations, and OCC responded with a Supervisory Letter warning Keystone that continued violations could lead to CMPs. The OIG believes the continued violations warranted progressively severe enforcement action, such as the issuance of CMPs rather than another informal action. (See page 17)

Subsequent examinations identified continued unsafe and unsound practices. OCC responded with a Formal Agreement, which Keystone signed in May 1998. The Formal Agreement also proved largely ineffective in getting Keystone to achieve full compliance or meet the initial agreed-to time frames for full compliance. Moreover, despite deficient management controls and systems, the Formal Agreement did not provide for any growth restrictions. (See page 18)

In 1998, Keystone continued to violate Call Report regulations, and OCC responded with CMPs totaling $23,000. Later that year, it was apparent that the CMPs were also ineffective because bank management continued to submit inaccurate Call Reports. (See page 21)

Prompt Corrective Action's (PCA) mandatory actions and restrictions had limited effect in mitigating Keystone's loss because of the bank's reported profitability and high capitalization levels. Although PCA restrictions were eventually triggered in June 1998, conditions appeared to have existed earlier to warrant the use of PCA's reclassification provision as a means to curb growth. (See page 22)

Recommendations and Lessons Learned

Until Federal law enforcement agencies complete their investigations, it is difficult to fully assess OCC's supervision of Keystone and the underlying causes that led to its failure. Nevertheless, the OIG believes Keystone offers several valuable lessons and opportunities to improve supervisory processes. To its credit, OCC has started a series of initiatives to improve examination procedures. (See page 29)

The OIG makes seven recommendations. Three recommendations focus on different aspects of assessing the level of reliance that should be placed on audited financial statements when the accuracy of the information is in question. Three other recommendations are aimed at reassessing the enforcement response when bank management is either not timely or not compliant in addressing problems covered in an enforcement action. Finally, the OIG recommends that OCC evaluate whether a different supervisory approach is needed to address growth in high-risk activities, accompanied by high profitability and adequate capitalization, without sufficient management systems and controls. (See page 26)

OCC Response and OIG Comments

OCC concurred with the OIG's findings and recommendations in its March 8, 2000 written response to the draft report. The Comptroller has formed a committee of senior deputy comptrollers to implement the recommendations. Planned corrective action, as well as the various initiatives already undertaken, is responsive to the intent of our recommendations. (See page 31)

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ABBREVIATIONS

ALLL	Allowance for Loan and Lease Losses
BIF	Bank Insurance Fund
CAMEL	Capital adequacy, Asset quality, Management administration, Earnings, Liquidity
CAMELS	Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, Sensitivity to market risk
CMP	Civil Money Penalty
EIC	Examiner-In-Charge
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Authority
FRB	Federal Reserve Bank
HLTV	High Loan-to-Value
IRS	Internal Revenue Service
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
TC&D	Temporary Cease and Desist Order
U.S.C.	United States Code

CHAPTER 1

INTRODUCTION

This report summarizes the Office of Inspector General's (OIG) review of the failure of The First National Bank of Keystone (Keystone) in Keystone, West Virginia. We conducted this review in response to our mandate under Section 38(k) of the Federal Deposit Insurance Act (FDIA). On September 1, 1999, the Office of the Comptroller of the Currency (OCC) declared Keystone insolvent after examiners were unable to verify $515 million in loans, nearly half of Keystone's reported assets. At the time of this report, the bank's failure had been attributed to alleged fraud, and law enforcement officials were still investigating the circumstances surrounding the unsubstantiated loans.[1]

Background

Keystone was incorporated in 1904 under the National Banking Act. The bank was situated in a depressed coal county in rural West Virginia. In 1977, Keystone was a small community bank with about $17 million in assets. That year, new management took over and essentially stayed in place until 1999.

According to OCC officials, in 1992 Keystone began an investment strategy that quickly transformed Keystone into a niche lender focusing on subprime mortgage loans[2] and total assets grew to approximately $107 million. Keystone reportedly provided the economic base for the community and was its major employer. In late 1993, Keystone began purchasing and securitizing Federal Housing Authority (FHA) Title I home improvement loans that were originated from around the country. Keystone's securitization program entailed purchasing FHA Title I loans, pooling the loans, then selling interests in the pooled loans through a securities underwriter. Keystone used commercial loan servicers throughout the country that collected the loan payments, maintained the individual loan account balances, and corresponded with the loan customers. Keystone sold the pooled loans, but retained a residual asset[3] portion of the securitized loans. By 1995, Keystone was reported to be one of the most profitable community banks in the country.

[1] Unsubstantiated loans are defined as assets that were included in Keystone's books but the bank was not able to verify the existence of the loans.
[2] Subprime mortgages are extended to borrowers exhibiting higher delinquency or default risks than traditional borrowers.
[3] Residual assets represent the cash flows, if any, that will be received in excess of the contractual servicing fee and other costs associated with securitized assets.

In 1997, Keystone began to develop and securitize its own high loan-to-value (HLTV) loans that were also targeted at highly leveraged borrowers with little or no collateral. The securitization of subprime loans became Keystone's main line of business and contributed greatly to its profitability and growth. From 1992, Keystone grew from $107 million to over $1.1 billion by 1999. This rapid growth was partly funded with above market rate deposits and brokered deposits.[4] Although the bank appeared highly profitable, Keystone's ten-fold growth in this high-risk area occurred without adequate accounting systems and controls, and despite regulators' concerns over bank management's lack of expertise in the area. Furthermore, the bank did not fully address OCC's concerns or fully comply with enforcement actions taken during the period and exhibited a pattern of repeatedly violating banking regulations.

Keystone's failure after such rapid growth under the aforementioned conditions may ultimately prove costly. The Federal Deposit Insurance Corporation (FDIC) has yet to finalize the cost of the bank's failure to the Bank Insurance Fund (BIF). FDIC estimated the loss, as of December 31, 1999, to be between $750 and $850 million. This loss will make Keystone's failure one of the largest losses in FDIC history.

Objectives, Scope and Methodology

FDIA's mandated objectives are to (1) ascertain why the bank's problems resulted in a loss to the insurance fund, (2) review OCC's supervision of Keystone, and (3) make recommendations for preventing any such loss in the future.

To accomplish our objectives, we conducted fieldwork at OCC Headquarters in Washington, DC; OCC's Atlanta District Office in Atlanta, Georgia; Charleston Field Office in Charleston, West Virginia; and the Ombudsman Office in Houston, Texas. Additionally, we visited the FDIC's Office of Inspector General in Washington, DC; Division of Supervision in Washington, DC and Atlanta, Georgia; Division of Resolutions and Receiverships in Dallas, Texas; and the Federal Reserve Bank (FRB) in Richmond, Virginia. We performed our fieldwork between September 1999 and January 2000.

[4] Brokered deposits are funds which a bank obtains, either directly or indirectly, by or through a broker, for deposit. A brokered deposit can be held by one or more investors.

Our review covered the period from 1992 to the bank's failure in 1999. In performing our review, we analyzed supervisory and enforcement files and records maintained by the OCC Headquarters, district, and field offices. We also reviewed records maintained by the FDIC and the FRB. In addition, we discussed various aspects of the supervision of Keystone with OCC officials, including examiners and attorneys. We also interviewed FDIC officials and examiners who had participated with OCC in three examinations at Keystone, or who were responsible for monitoring Keystone for federal deposit insurance purposes.

The audit was conducted in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States, and included such audit tests as were deemed necessary. At the time of this report, Federal law enforcement officials were still investigating the alleged fraud surrounding the $515 million in unsubstantiated loans, as well as related matters. Therefore, we could not fully assess the cause of the bank's failure.

For a more detailed discussion of our objectives, scope and methodology, refer to Appendix 4.

WHY KEYSTONE CAUSED A LOSS TO THE FUND

Keystone's insolvency was established when the bank was unable to account for $515 million of loans, nearly half of the $1.1 billion in reported assets. According to OCC's Bank Closing Report, examiners found that the Bank engaged in an unsafe or unsound banking practice of including on its balance sheet loans that it did not own. The overstated assets were attributed to alleged fraud. Keystone's inadequate accounting systems and controls helped mask this alleged fraud.

On June 21, 1999, OCC and FDIC began a joint on-site examination of Keystone. A primary focus of the review was to determine the asset quality of the loan portfolio. In reviewing the loan balances between the bank and servicer reports, the examiners found inconsistencies in the loans listed, the principal balances, and due dates. Because Keystone management did not adequately explain the items in question, the examiners initiated their own independent verification of assets and contacted loan servicers directly to confirm loan balances. This led to the discovery on August 23, 1999 of the $515 million discrepancy in loans reported by Keystone and confirmed by the servicers, as outlined in Table 1.

Table 1
Discrepancy in Loans Owned and Serviced
as of June 30, 1999
($ in millions)

Loan Servicer	Loans Owned		
	Keystone Reported	Servicer Confirmed	Adjustment (Reduction)
A	$320	$32	($288)
B	233	6	(227)
Total	$553	$38	($515)

Source: OCC Bank Closing Report

The portfolio of loans reported by Keystone was 14 times more than the amount confirmed by the loan servicers. Bank management contended that the discrepancy was due to reporting errors by loan servicers and that the disputed loans would be found. Up to the day of its closure, bank officials could not verify the existence of the reported loans, or explain the accounting discrepancy.

Adequate accounting and financial controls are the fundamental basis for OCC's risk-based examination approach. OCC examiners typically did not independently verify the bank's reported loan balances. Examiners relied on the bank's external auditors to ensure the accuracy of reported assets. A national public accounting firm issued an unqualified opinion on Keystone's December 31, 1998 financial statements. However, when informed in August 1999 by examiners about certain reporting discrepancies, the accounting firm did not adequately explain its assertion that the loan portfolio had been properly confirmed. This situation further influenced regulators' decision to visit the loan servicers and conduct an independent verification of the booked loans.

The OCC used its receivership authority under FDIA after finding evidence of apparent fraud that resulted in the depletion of the bank's capital. Allegations of fraud are presently under investigation by Federal law enforcement officials.

OCC'S SUPERVISION OF KEYSTONE

From 1992, OCC examined Keystone each year up through the bank's closing in 1999. These examinations were conducted under a strained relationship with bank management marked by mutual distrust, resistance to examiner findings, and ended in perceived threats against OCC examiners and the intervention of law enforcement officials.

OCC's examinations generally focused on the credit risk associated with subprime mortgage loan securitizations. Rather than credit risk, however, Keystone's insolvency resulted from the unsubstantiated loans, which had been masked by inaccurate financial reports. It was not until August 1999 that OCC independently verified reported loan balances and surfaced the unsubstantiated loans. However, the pattern of reoccurring accounting and internal control problems by 1997, and Call Report violations coupled with Keystone's inability or unwillingness to take corrective action would suggest that verifications were warranted before 1999.

In response to finding unsafe and unsound banking practices, OCC issued several enforcement actions and Civil Money Penalties (CMP) for bank regulatory violations. These enforcement actions were largely ineffective in getting Keystone to fully address its operating deficiencies, some of which were critical to the accounting, financial reporting, and control problems. In addition, OCC's enforcement actions did little to curb Keystone's high-risk growth. Based on our review of OCC's enforcement files and related documents, we do raise several observations relative to the timeliness of enforcement actions, the type of enforcement actions used and the applicability and effectiveness of PCA.

Given the alleged fraud, it would be speculative to suggest that earlier loan verifications would have surfaced the unsubstantiated loans sooner and thus minimized or prevented BIF losses. Furthermore, it is difficult to fully gauge the adequacy of OCC's enforcement response to problems identified in examinations and in minimizing the loss to BIF.

Bank Examination Results

Each year from 1992 to 1999, OCC conducted an on-site examination at Keystone. Because of heightened concerns about Keystone's loan securitization activities, OCC brought in some of its capital markets and securitization specialists to assist in evaluating Keystone's mortgage banking operation beginning in 1995. Furthermore, in late 1997, OCC transferred the bank's supervision from the Southeastern District to the Special Supervision and Fraud Division in Washington, DC.

During the 1990s, OCC's supervision of Keystone was complicated by a strained relationship with bank management. OCC officials described bank management as uncooperative, combative, secretive and manipulative. Bank management boasted of its incredibly high earnings and strong capital and continued to expand its mortgage loan securitization operations. Keystone management also routinely contested examination findings and made various charges against the examiners to discredit the examinations. This included attempts to get third parties to intercede by complaining to U.S. Senators and directly to senior OCC officials. Bank management also hired consultants, including a former Comptroller of the Currency, to assist in addressing OCC's concerns. According to OCC senior officials, these attempts did not affect OCC's supervision of the bank.

According to OCC and FDIC officials, Keystone management also impeded on-site examinations by restricting access to bank employees and records. Basic documents, such as trial balances and general ledgers, were not made readily available, and some documents had to be repeatedly requested. According to OCC officials, bank management responses were so untimely that examiners did not have time to review them before having to move onto the next scheduled bank examination. OCC officials said Keystone management seemed well aware that examiners had set timeframes for completing an on-site examination and that by stalling the examination process long enough, examiners would eventually leave the bank with issues unresolved.

OCC's relationship with Keystone management was particularly strained when OCC issued two criminal referrals in 1995 against two senior bank officers for falsifying bank records relating to Regulation Z, *Truth in Lending Act*, and misapplying bank funds. [redacted]. In 1999, the relationship became even more contentious when OCC discovered that bank officers secretly taped phone calls with OCC employees and objected to its examiners working in an area viewed by a security camera. The strained relationship peaked when the U.S. Marshals Service was asked to provide security for the examiners at Keystone.

Beginning in 1992, OCC routinely identified problems with Keystone's internal controls and accounting systems, including internal and external auditing deficiencies, as shown in Table 2 on the next page. (Also, see Appendix 3 for a detailed chronology of significant events regarding Keystone.)

Table 2
OCC Examinations and Supervisory Response
(1992 to 1999)

Date Exam Started[5]	CAMELS[6] Rating	Significant Safety and Soundness Issues	Date of Action	Supervisory Response/ Enforcement Actions Taken
1/6/92	2/21312	• System and internal control deficiencies • Inadequate policies, systems and controls • Call Report violations	3/19/92	• Commitment Letter
7/12/93	2/21312	• Lack of comprehensive internal/external audit functions • No policies and procedures for FHA Title I loan program • No policy guidelines developed for Interest Rate Risk management • Concerns over certificates of deposit investments • Inadequate documentation of internal loan reviews • Truth in Lending Act (Reg. Z) violations	10/28/93	• Revised Commitment Letter
4/11/94	2/22322	• Repeat Call Report violations • Concerns with treatment of gain on loan sales and loan administration • Falsification of bank records regarding Truth in Lending Act reimbursements • [redacted]	9/8/94 5/5/95 5/5/95	• Supervisory Letter issued for Call Report violations • Criminal referral for falsification of bank records relating to Reg. Z violation • [redacted]
5/8/95	2/22322	• Accounting and control issues identified, especially the FHA Title I program	1/24/96	• Commitment Letter terminated
6/5/95	3[7]	• Operational deficiencies surrounding the FHA Title I loan securitization program • 11/3/95 - FDIC downgrades Keystone's CAMEL rating based on the 5/8/95 examination • 1/22/96 - bank appealed exam rating of 3 to Ombudsman	5/30/96	• Ombudsman upheld rating
6/17/96	2/22212	• Bank's financial condition was sound • FDIC participated in the exam	None	
7/28/97	3/344433	• Concerns with controls over FHA Title I loan program securitizations • Loans not being charged-off • Unacceptable internal audit • Call Report violations • Inadequate provision for loan loss	5/28/98 8/6/98	• Formal Agreement • CMPs issued for Call Report violations
8/31/98	4/445444	• Insufficient progress with Formal Agreement • Unsafe concentration of mortgage products • Bank illegally accepted brokered deposits • Inaccurate Call Reports • FDIC participated in the exam	7/5/99	• CMPs initiated but not issued for Call Report and brokered deposit violations
6/21/99	No Rating Assigned	• Illegally accepted brokered deposits • Backdated brokered deposit records • Loans reported on bank's books not owned by Keystone • FDIC participated in the exam	9/1/99	• Bank closed

Source: OCC's Supervisory Monitoring System, Reports of Examination and Examination Workpapers

[5] Exam start date per Report of Examination (ROE).

[6] The first number is the composite rating. A rating of 1 through 5 is given, with 1 having the least regulatory concern and 5 having the greatest concern. Individual components of the CAMEL rating system are Capital adequacy, Asset quality, Management administration, Earnings and Liquidity. Effective 1/1/97, an additional component addressing Sensitivity to market risk was added to the examination ratings under OCC-B-97-1, *Uniform Financial Institutions Rating System and Disclosure of Component Ratings*.

[7] OCC conducted a special examination, concentrating on the FHA Title I loans and securitization program. The 3 rating was the bank's composite CAMEL rating.

Keystone's accounting system problems included inadequate loan inventory controls, poor reconciliation processes, and weak loan administration. Furthermore, the OCC examiners repeatedly cited Keystone for Call Report violations (12 U.S.C. §161). Between 1992 and 1998, OCC cited Call Report violations in 4 of the 7 examinations and at various times between examinations.

OCC examiners said they were never completely "comfortable" with the bank's mortgage securitization operation. According to OCC documents, Keystone management's emphasis was on earnings and growth although they did not have the expertise, proper controls and systems to manage the associated risks. Indeed, OCC typically rated Keystone's management 3 or worse under the uniform financial institutions rating system. The 1996 examination was the one exception in which OCC rated bank management 2. In 1996, OCC conducted the examination at Keystone with FDIC participation.[8] OCC examiners found bank management had taken positive steps to improve core bank activities and the FHA loan program. Given the problems found in prior examinations, the significantly lower rating given just one year later, and the eventual closing of the bank, the 1996 examination results seemed inconsistent. However, based on our review of OCC examination records and discussions with OCC officials, we determined that the basis for their 1996 examination conclusion was that bank management was making progress on several fronts including inventory controls, reconciliations, and other quality controls measures.

Keystone's Accounting Records

OCC's examination reports were replete with indications that Keystone's accounting systems and financial reports were unreliable, and the associated controls were deficient. It should be noted that examination procedures did not require an independent verification of loan balances. Instead, examiners typically relied upon the work of external auditors and the bank's internal audit function as a fundamental management control. OCC did not verify Keystone's loan balances until 1999.

Our review of OCC documents and interviews with OCC examiners revealed that OCC identified weaknesses in the internal and external audit functions, and other "red flags" that indicated Keystone's financial records were unreliable. Although we could not conclude that earlier verifications by OCC would have detected Keystone's apparent

[8] FDIC's participation focused on Keystone's FHA Title I Loan program and its risks.

$515 million loan balance discrepancy, OCC's delayed verification under the circumstances point to a potential weakness in OCC's examination procedures. These procedures placed heavy emphasis on assessing controls rather than performing transaction testing and account verification.

A chronology of the red flags and early warning indicators follows:

The 1992 and 1993 examinations reported that the bank did not have effective internal and external audit functions to verify account balances.

In 1994, OCC found that two senior bank officers violated "Truth in Lending" regulations, for apparently falsifying bank documents and misapplying bank funds. OCC filed criminal referrals with the United States Attorney. [redacted]

In 1995, OCC examiners found that the bank's FHA total loan portfolio of $130 million was out-of-balance by $8 to $12 million. This discrepancy was attributed to the absence of basic accounting controls, such as account reconciliation and poor management information systems.

In 1997, OCC examiners found recurring and far more significant problems. Specifically, the bank's:

- poor accounting systems and controls resulted in record keeping errors, inaccurate reporting, misstatements of balance sheet and income statement accounts, and questionable account integrity.
- loan database contained inaccuracies especially pertaining to loan balance and delinquency status. Inaccuracies in the database reports prevented the OCC from placing reliance on the report.
- procedures for reconciling general ledger accounts did not appear acceptable, and bank management could not provide general ledger details to support account balances.

OCC examiners suggested that Keystone may have been "sanitizing" information before providing it to OCC. Examiners were concerned that false management information system information was an issue and commented that OCC would "...have to be able to get info (sic) direct from the servicers in order to know."

The 1998 examination records show that OCC again encountered numerous problems. OCC:

- continued to receive inaccurate reports, including Call Reports and supporting worksheets. OCC noted problems with bank management's unwillingness or inability to follow accounting guidelines and comply with laws and regulations. This was demonstrated in the September 30, 1998 Call Report where bank management appeared to estimate data to achieve the desired Prompt Corrective Action (PCA) category of "well capitalized."

- found significant weaknesses in accounting practices and risk management systems. Books and records continued to be inaccurate. Likewise, during this joint examination, FDIC examiners found errors in virtually everything they reviewed.

- telephoned one of the bank's loan servicers to confirm loan balances on servicing reports. The examiner found out that the information provided to them by Keystone was not coming directly from the servicer. The servicer told the examiner that the reports were produced by Keystone internally and not by the servicing company. Despite this information, OCC officials said they accepted the bank's explanation and did not pursue the matter further.

Even though examiners routinely identified these accounting, reporting, and control problems, OCC did not directly verify the existence of bank assets and reliability of financial records until the 1999 examination. By then, bank assets had grown from $850 million in 1997 to over $1.1 billion in 1999.[9]

[9] Part of the growth was attributed to the booking of residual assets according to Financial Accounting Standards Board No.125.

According to OCC officials and documents, direct verifications were not performed for two reasons:

- OCC relied on bank management and external auditors to confirm the existence of bank assets held by third parties pursuant to generally accepted auditing standards, which was in line with OCC's risk-focused examination approach.

- bank management expressed concern that OCC's direct contact with the loan servicers to verify loan balance reports would harm the bank's reputation and likely impair its ability to sell loans in the market. And OCC did not want to cause harm to the institution.

Conclusions on OCC's Bank Examination Results

OCC actively supervised Keystone as reflected by annual on-site examinations. OCC examiners appeared to focus mostly on the highly technical and risky area of securitizing subprime mortgages. In hindsight, however, it was the unsubstantiated loans that had been masked by inaccurate books and records and not credit risk that led to Keystone's insolvency. The insolvency occurred in 1999 when loan balances were verified.

Earlier verification appeared warranted, possibly as early as 1997, given the recurring financial control weaknesses, the presence of uncooperative bank management, the possible management integrity issues, and the repeated regulatory violations.

It is unclear whether earlier verification by OCC would have detected unsubstantiated loans sooner, minimized eventual losses to the BIF, or detected fraud. Nevertheless, the supervisory history of Keystone points to a potential fundamental weakness in OCC's examination process. Under OCC's risk-based approach, examiners may have placed too much reliance on audited financial statements especially when conditions would suggest otherwise. Furthermore, to the extent that Keystone's overstated loan balance is due to fraud, OCC's examination procedures might not have been sufficient to detect fraud.

Enforcement Actions

From 1992 through Keystone's closing in 1999, OCC had issued several enforcement actions and CMPs for bank regulatory violations. These enforcement actions were largely ineffective in getting Keystone to fully address its operating deficiencies, some of which were critical to the accounting, financial reporting, and control problems.

As previously noted in Table 2, OCC issued both informal (i.e., Commitment Letter and Supervisory Letter) and formal (i.e., CMPs and Formal Agreement) enforcement actions between 1992 and 1999. Chart 1 shows that these actions had little effect in curbing Keystone's growth, which ultimately will impact the size of the loss to the BIF.

Chart 1
Keystone's Asset Growth and OCC's Enforcement Actions
(1992 to 1999)

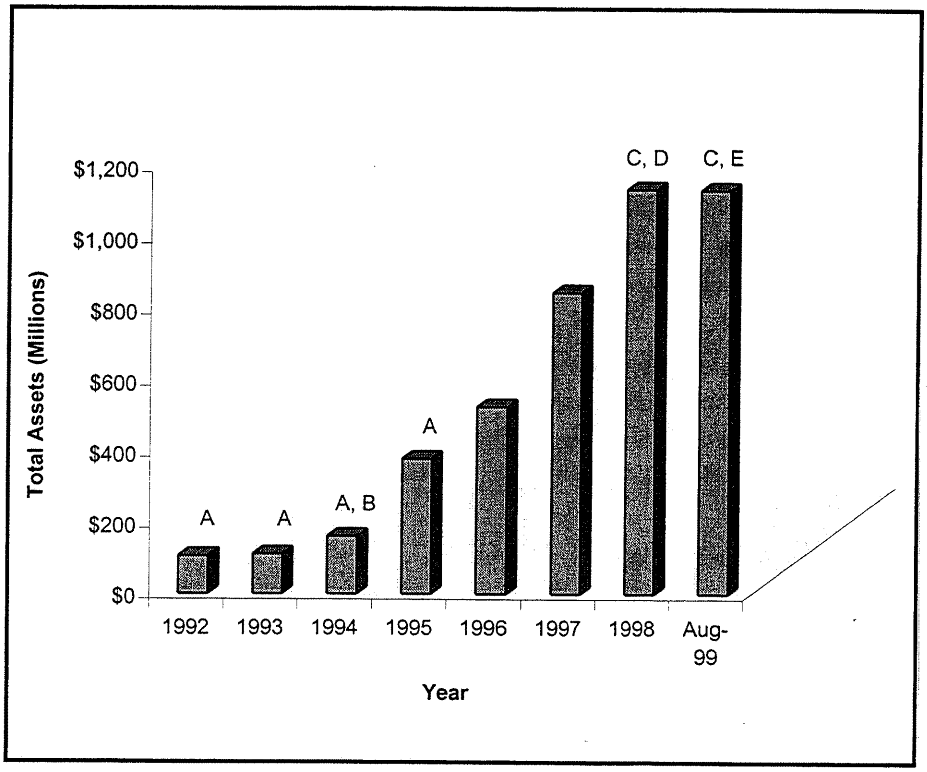

Chart 1 Shows the Years OCC Enforcement Actions Were in Effect
A = 1992/1993 Commitment Letter Issued/Revised
B = September 1994 Supervisory Letter Issued
C = May 1998 Formal Agreement Issued
D = August 1998 CMPs Issued
E = July 1999 CMPs (put on hold)

Source: Keystone's Call Report data and OCC documents

Commitment Letter

Although the 1992 Commitment Letter adequately addressed the problems found in the January 1992 examination, the Letter was not effective in compelling Keystone to correct the problems. By extending the enforcement action for nearly four years, OCC allowed Keystone a protracted time period to address the problems. When OCC eventually terminated the letter, the underlying problems were not fully resolved, the promised corrective actions were not fully implemented, and similar problems resurfaced in subsequent examinations. Rather than terminating the Commitment Letter, perhaps progressively severe action would have been warranted. Furthermore, OCC terminated the Commitment Letter immediately after downgrading Keystone's composite CAMEL rating from 2 to 3.

Unusually Long Period Afforded Bank to Comply

OCC issued a Commitment Letter in March 1992. The Letter addressed many unsafe and unsound banking practices, including inadequate audit functions, incorrect Call Reports, and weak internal controls and systems. According to OCC records, Keystone made some progress in correcting the problems. But in October 1993, OCC revised the Commitment Letter upon identifying additional problems and areas requiring further work. Table 3 shows OCC's major concerns in the revised Commitment Letter.

Table 3
Revised Commitment Letter of October 28, 1993

Major Corrective Actions Needed	Established Timeframes
Develop a comprehensive policy to guide the FHA Title I loan securitization program	60 days
Develop comprehensive internal and external audit functions	60 days
Implement an effective interest rate risk management program	90 days
Obtain confirmations of certificates of deposit	By year end
Improve internal loan review documentation	45 days
Correct violations of law cited in the ROE	Immediate

Source: OCC Revised Commitment Letter

Based on the original established timeframes, Keystone should have fully complied with the revised Commitment Letter by February 1994. Keystone did not comply with the established timeframes. OCC subsequently extended the Letter for an additional two years. In

January 1996, OCC terminated the action, maintaining that Keystone had achieved substantial compliance. Keystone's management provided assurances to OCC that safety and soundness concerns would be met.

OCC officials told us that a Commitment Letter should not continue for more than one or two years, when more severe enforcement action may be needed to compel bank management to address problems. Keystone was given more time because, according to the examiners-in-charge (EIC), progress was being made on corrective actions.

Problems Addressed in Commitment Letter Resurfaced in Later Years

The problems identified in the 1992/1993 Commitment Letter were not fully corrected when OCC terminated the Letter. At that time, a progressively forceful action addressing unresolved problems seemed more appropriate because control and system problems resurfaced. For instance, in the June 1996 examination, OCC again identified problems in Keystone's internal audit and loan review functions. These issues had been previously included in the original 1992 Commitment Letter. Without an enforcement action in effect, Keystone's control and system problems continued for two more years until they were again included in the 1998 Formal Agreement. Table 4 shows similar corrective actions cited in the 1992/1993 Commitment Letter and the 1998 Formal Agreement.

Table 4
Corrective Actions Cited in Both Commitment Letter and Formal Agreement

Establish internal audit program
Engage external audit firm
Correct loan administration program
Establish independent loan review
Enhance allowances for loan and lease losses (ALLL) program
Implement interest rate risk and funds management improvements
Implement management and personnel improvements
Implement management information systems improvements
Correct violations of law and regulation

Source: 1992/1993 Commitment Letter and 1998 Formal Agreement

OCC Downgraded Keystone's Composite Rating but Terminated the Commitment Letter

In December 1995, OCC downgraded the bank's composite CAMEL rating from 2 to 3. OCC decided to take a formal administrative action against the bank unless the bank corrected the problems by January 31, 1996. Immediately afterwards in January 1996, OCC terminated Keystone's Commitment Letter, maintaining that Keystone had substantially complied with the intent of the Letter. These two actions appear to be contradictory. An EIC said that although the bank's condition had deteriorated, the Letter was no longer relevant because it did not address the bank's current problems. OCC, however, did not take any action based on the bank's composite 3 rating because the bank appealed the rating. Instead, OCC decided to review the bank's corrective actions during the 1996 examination. Thus, OCC did not take further action until the Formal Agreement was issued on May 28, 1998. OCC officials indicated, in hindsight, that either a revised or a new enforcement action may have been more appropriate to compel bank management to resolve the problems. Without an effective enforcement action or the necessary cooperation of bank management, Keystone's control and system problems persisted.

Supervisory Letter

OCC issued a Supervisory Letter on September 8, 1994 for Call Report violations identified in the April 1994 examination. The Call Report violations were for the quarters ended December 31, 1993 and March 31, 1994, and entailed inaccuracies related to past due and non-accrual loans, misclassification of investment securities and borrowing transactions.

The Supervisory Letter served as a formal notification to bank management of its obligation to develop and implement Call Report procedures to prevent future violations, and warned that Call Report violations in the future may result in CMPs. OCC issued the Supervisory Letter while the Commitment Letter was still in effect.

The use of a Supervisory Letter while another informal action was already in effect for Call Report violations proved to be ineffective and redundant. The Call Report problem had already been identified in OCC's 1992/1993 Commitment Letter. When Keystone did not comply with the Call Report provision of the Letter, a progressively severe enforcement action seemed warranted. Despite these two enforcement actions, Keystone continued to submit inaccurate reports until its closure in 1999.

CMPs May Have Been Warranted Instead of a Supervisory Letter

Keystone demonstrated a pattern and practice of violating Call Report regulations. Between 1992 and 1998, Keystone was cited for Call Report violations in 4 of the 7 examinations conducted by OCC.

Violations of law and regulation were cited in the 1992/1993 Commitment Letter. By 1994, OCC indicated that Call Report violations were significant, appeared more willful than the 1992 violations, and that sufficient basis existed for an enforcement action. Call Report errors found in the 1994 examination were more obvious because the errors involved traditional banking activities.

In the 1995 and 1996 examinations, OCC did not cite Call Report violations, but OCC maintained that Keystone did not ensure the accuracy of Call Reports and identified improper accounting procedures that would have likely affected the bank's ability to file accurate Call Reports. Call Report violations were again found in 1997 and 1998.

In August 1998, OCC eventually issued CMPs for the Call Report violations. But the CMPs were ineffective deterrents or punishments because Keystone continued to submit inaccurate Call Reports until the bank's closure in 1999.

Formal Agreement

After the Commitment Letter was terminated in 1996, problems resurfaced at Keystone. OCC's enforcement response was to have Keystone sign a Formal Agreement in 1998. According to OCC officials, a Formal Agreement was the appropriate enforcement action to take. As with the prior enforcement actions, this also proved ineffective, particularly with respect to the accounting, reporting, and controls problems. Keystone management did not fully implement the terms of the Formal Agreement and had not been fully cooperative with OCC examiners, according to OCC officials. In hindsight, OCC officials opined that most enforcement actions would not have been effective because of bank management's contentious and uncooperative tactics. Nevertheless, the Formal Agreement lacked a growth restriction provision that may have curbed Keystone's growth and ultimately the size of the loss. The conditions at the time, such as the bank's accounting, reporting, and control problems, also raises the issue as to whether the Formal Agreement was timely.

OCC issued a Formal Agreement on May 28, 1998 to address the problems identified in the examination started in July 1997. Those examination findings elevated OCC's concerns about the bank's condition. Specifically identified were poor supervision and administration of the bank's loan program, and the bank's asset quality deterioration.

As with the Commitment Letter, Keystone was unable or unwilling to fully address the Formal Agreement within the agreed timeframes. The Formal Agreement had generally set a 60 day timeframe for full compliance, which would have been in July 1998. As Table 5 shows, OCC concluded in the August 31, 1998 examination that the bank was non-compliant with four provisions, partially compliant with six provisions, and fully compliant with three provisions. The remaining two provisions did not require action.

Table 5
Keystone Generally Did Not Comply with the Formal Agreement

Formal Agreement Provisions May 28, 1998	Level of Compliance August 31, 1998	Established Timeframes (approximate)
Submit monthly progress reports	Partial	30 days
Retain external audit firm	Partial	30 days
Select Chief Financial Officer	Compliance	60 days
Ensure accuracy of books, records, and Call Reports	Non-Compliance	30 days
Develop loan administration program/managing risk	Partial	60 days
Establish Internal Loan Review System	Partial	60 days
Establish ALLL Program	Non-Compliance	30 days
Analyze new products and services	Compliance	Prior to involvement
Implement internal audit program	Partial	30 days
Correct violations of law or regulation	Non-Compliance	60 days
Implement strategic plan	Non-Compliance	60 days
Monitor liquidity/interest rate risk	Partial	90 days
Implement Bank Information System	Compliance	45 days

Source: 1998 Formal Agreement and August 31, 1998 ROE

Formal Agreement and Growth

The Formal Agreement addressed all the problems found in the examination, but did not include a provision to curb growth. A growth provision could have been adopted until the bank achieved compliance with the other provisions of the Formal Agreement. In fact, OCC records indicated that the bank increased its HLTV loans another $100 million during the fourth quarter of 1998. Furthermore, these loans increased the bank's total concentration of HLTV loans from 510 percent to 525 percent of capital.

OCC indicated that curbing growth would have effectively shut down the bank, and could not be justified, given the bank's profitability. While the OIG understands the dilemma OCC was facing at the time, the situation raises the question as to when should growth and/or profitable activities be curbed if fundamental controls to ensure reliable books and records have been historically deficient. Furthermore, by 1998 the bank had demonstrated a pattern and practice of noncompliance with other enforcement actions, repeated regulatory violations, potential management integrity issues, and less than satisfactory management, as reflected in its CAMELS ratings.

Given Keystone's historical lack of cooperation with OCC, the OIG believes that it is unlikely OCC would have gotten Keystone to agree to a Formal Agreement provision curbing growth, or to consent to an equivalent article in a Cease & Desist Order. Therefore, using a Temporary Cease and Desist (TC&D) would have been a means to restrict growth as an interim measure. A TC&D takes immediate effect when management will not agree or consent to a Formal Agreement or Cease & Desist Order. The TC&D remains in effect unless overturned by the court or until a final Cease & Desist Order is in place.

The bank's condition at the time appeared to meet the requirement for a TC&D. Specifically, the bank's books and records were so inaccurate that the OCC was unable to determine the financial condition of the bank. At the time, several OCC officials opined that conditions existed to use a TC&D as an appropriate action. However, OCC senior officials told us that, at the time, the Formal Agreement was more appropriate because OCC could achieve everything they wanted through this action. Specifically, they said that the Formal Agreement (1) was more comprehensive, (2) had the same legal ramifications as a TC&D, (3) the bank was willing to agree to the Formal Agreement, and (4) the bank was not in imminent danger of failing. The OIG does not believe that the TC&D was a better enforcement action than the Formal Agreement, but that the TC&D may have been a means to curb growth. Curbing growth was not covered by the Formal Agreement.

Timeliness of Formal Agreement

In our opinion, the Formal Agreement could have been issued as early as January 1998 rather than in May 1998. OCC issued the Formal Agreement nearly six months after reporting the results of the July 1997 examination. OCC delayed issuing the Formal Agreement for several reasons:

- Keystone management was given additional time to respond to the December 1997 Report of Examination because OCC transferred supervision of the bank from the Southeastern District to Headquarters' Special Supervision and Fraud Division in September 1997.

- Keystone's Chairman passed away in October 1997, and OCC did not want to issue an enforcement action during bank management's transition period.

- OCC relied on Keystone's commitment to spin-off its existing FHA mortgage loan activity into a non-bank affiliate. OCC believed the spin-off would remove the higher risk assets from the bank's balance sheet, improve the quality of the loans, and improve the bank's risk profile. The spin-off that was to have occurred on December 15, 1997 was extended to March 31, 1998. However, the proposal never materialized because of bank management's inability to secure financing for the proposed affiliate.

OCC officials opined that the Agreement was issued timely given the circumstances. However, in our opinion, existing conditions may have called for a more urgent response. From January 1996 to May 1998, Keystone was not under an enforcement action, although OCC had identified continuing problems with Keystone's accounting, reporting and internal controls. Therefore, a more timely implementation of the Formal Agreement may have been warranted.

Civil Money Penalties

In August 1998, OCC issued CMPs against Keystone management for submitting inaccurate Call Reports in each quarter of 1997. OCC initially assessed a $25,000 CMP against one officer and $10,000 CMP against each of five directors. OCC negotiated a settlement for $13,000 against the officer and $2,000 against each of the five directors. The dollar amounts assessed did not deter Keystone management from continuing to violate banking laws and regulations.

In June 1999, OCC again approved CMPs for Call Report and brokered deposit violations found in the second and third quarters of 1998. OCC initially assessed a $100,000 CMP against one officer and $25,000 CMP against each of six directors. However, OCC asked for a stay in imposing the CMPs when Keystone claimed that they discovered OCC documents disparaging bank management and obtained a temporary restraining order against OCC. CMPs may still be imposed once the Federal law enforcement investigation is completed.

Prompt Corrective Action

PCA's mandatory actions and restrictions had limited effect in mitigating Keystone's loss because of the bank's reported profitability and high capitalization levels. These PCA actions and restrictions are dependent on accurate books and records, and are triggered based on bank capital, a lagging indicator of unsafe and unsound practices. Although PCA's restrictions were eventually triggered in June 1998, conditions appeared to have existed earlier to warrant the use of PCA's reclassification provision as a means to curb growth.

<u>PCA Intended to Provide Prompt Resolution of Bank Problems</u>

The intent of PCA is to promptly resolve a bank's problems at the least possible long-term loss to the deposit insurance fund. This is to be accomplished through a system of progressively severe regulatory intervention as bank capital levels fall below prescribed categories. PCA classifies banks into five capital categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." A bank with capital in the three lower capital categories is considered "undercapitalized" and is automatically subject to certain mandatory restrictions and supervisory actions. These actions include, but are not limited to, submitting a capital restoration plan to OCC and restricting its asset growth. PCA does not replace but supplements enforcement actions available to regulators to address unsafe and unsound banking practices.

Potential Limitation of PCA

PCA's effectiveness is largely triggered by bank capital levels, and is dependent on the accuracy and reliability of the financial records. Because capital is the primary underpinning of PCA, OCC needed to determine Keystone's true financial condition before taking progressively severe regulatory actions and restrictions to address bank problems.

However, with assets overstated by nearly 50 percent, as identified in August 1999, OCC did not have an accurate picture of Keystone's capital level. In fact, the 1998 examination report noted that bank management appeared to estimate data to achieve the desired PCA category of "well capitalized."

PCA is most effective when there is a gradual decline in a bank's capital category because more severe restrictions are triggered as capital declines. In Keystone's case, its capital category went immediately from "adequately capitalized" to "critically undercapitalized" when $515 million in unsubstantiated loans were identified in August 1999.

Reclassification Provisions

PCA is not solely tied to capital levels in order to use certain discretionary actions and restrictions. These actions are available through a PCA provision referred to as reclassification. This essentially entails reclassifying a bank's capital level to the next lower category if a bank is in an unsafe or unsound condition, or engages in an unsafe or unsound practice.[10] In so doing, the actions and restrictions provided under the next lower capital category can then be used.

In Keystone's case, there may have been an advantage to using the reclassification provision. By reclassifying the bank after the 1997 examination in January 1998 from "well capitalized" to "adequately capitalized," OCC could have restricted the bank's use of brokered deposits and certain interest-rate restrictions. Thus, OCC could have curbed the bank's growth six months before the bank's capital levels actually fell and triggered these restrictions automatically in June 1998. This action may have curtailed the bank's deposit growth from $545 million in December 1997 to over $638 million by June 1998. Of the $90 million in deposit growth during this 6 month period, we could

[10] 12 U.S.C. §1831o(g). Section 8(b)(8) of the FDIA defines an unsafe or unsound practice to be (1) the institution has received a less than satisfactory rating in its most recent examination report for assets, management, earnings, or liquidity, and (2) the institution has not corrected the deficiency.

not determine the true brokered deposit amount because the bank did not correctly identify its brokered deposit base.

On June 29, 1998, PCA growth restrictions were triggered after Keystone's capital was adjusted as required by OCC. The adjustments resulted in lowering the capital category from "well capitalized" to "undercapitalized." However, there may have been a basis for curbing growth sooner by invoking PCA's reclassification provision based on the July 1997 examination, when the report was completed on December 19, 1997. The examination, which resulted in a composite rating of 3, cited numerous unsatisfactory conditions and uncorrected deficiencies. For example:

- The bank's condition was less than satisfactory.
- Management and Board supervision were unsatisfactory, a condition based in part on deficiencies identified in previous examinations. One repeat deficiency was the absence of a comprehensive internal audit program.
- Earnings, as reported, were inaccurate and overstated.
- The bank's funding structure subjected it to higher liquidity risks because Keystone was heavily dependent on savings and certificate of deposit accounts well above market rates.
- Accounting systems and controls were seriously deficient.

In addition, an OCC capital markets specialist who assisted in the 1997 examination cited additional unsafe and unsound practices in an internal memorandum to a senior OCC official. In a November 1997 memorandum, the specialist recommended that OCC should consider requiring Keystone to cease its FHA Title I lending program until the bank could provide an accurate management information system, as well as accurate books and records. The specialist further stated that additional lending activity will only compound an already problem situation.

Even though reclassification may have been a means to curb growth sooner, it is unclear whether that would have been any more effective than the other enforcement actions used since 1992. For example, after the June 1998 brokered deposit restrictions were triggered, OCC found during the August 1998 examination that "the bank continued to accept, renew or roll over brokered deposits, or solicit other deposits by offering an effective yield that exceed the limits set by the regulation during the period of time the bank was undercapitalized." Moreover in the 1999 examination, FDIC and OCC examiners found that Keystone violated the

PCA restrictions intentionally to obtain $280 million of brokered deposits.

Conclusions on OCC's Enforcement Actions

OCC routinely identified unsafe and unsound banking practices, found regulatory violations, and responded with a series of enforcement actions. None of the actions were substantively effective, particularly in addressing the accounting, reporting and control problems that may have masked Keystone's overstated loan balances. Keystone repeatedly violated banking regulations, continually engaged in unsafe and unsound practices, and did not demonstrate the capacity to adequately manage high-risk activities, such as subprime lending and asset securitization. Given the possibility of fraud, it is difficult to say if any enforcement actions would have been effective.

Even though OCC issued several enforcement actions, one aspect of Keystone's activity that was not addressed was growth. Assets grew ten-fold during a period when OCC routinely found that Keystone (1) lacked fundamental risk controls and systems, such as accurate books and records, (2) was uncooperative with examiners, (3) engaged in activities that raised questions about management's integrity, and (4) did not adequately manage high-risk activities. Without some provision to curb growth, Keystone exposed the BIF to increasingly higher levels of risk.

Given the sudden discovery of unsubstantiated loans, PCA, as an enforcement tool, was limited in mitigating Keystone's loss to the insurance fund. However, OCC also did not use PCA's reclassification provision. The OIG believes reclassification may have been a way to curb growth during the first half of 1998.

CHAPTER 4

RECOMMENDATIONS AND LESSONS LEARNED

The specific underlying causes of Keystone's failure remain unknown until Federal law enforcement officials complete their investigations. As a result, the OIG was unable to fully assess the adequacy of OCC's supervision of Keystone. Nevertheless, the OIG believes that Keystone offers several valuable lessons and opportunities to improve the supervisory process. To its credit, OCC has already undertaken several initiatives to improve examination polices and procedures. Based on facts known to date, the OIG also has seven recommendations that focus on examination and enforcement procedures.

Recommendations

Recommendations 1 - 3

In Chapter 3, we noted that Keystone's financial accounting, reporting and underlying control problems had repeatedly surfaced in OCC examinations at least since 1992. However, verification of Keystone's reported loans was not conducted until 1999. The loan verifications revealed that total assets were overstated by nearly 50 percent, and Keystone was unable to account for over $500 million in unsubstantiated loans. Aside from the potential underlying fraud aspects of this discovery, we believe that OCC's risk-based examinations may place undue reliance on external auditors to ensure the accuracy of financial information that is vital to detecting unsafe and unsound banking practices.

Accordingly, the OIG recommends that the Comptroller of the Currency:

1. Issue either new or supplemental examination guidelines requiring a risk assessment of a bank's financial accounting, reporting, and controls as an integral part of assessing the bank's overall risk.

2. Develop detailed examination guidelines and/or indicators as to when full reliance may not be placed on a bank's external audited financial statements and related accompanying statements.

3. Establish guidelines and supplemental examiner training, on testing procedures when full reliance may not be placed on audited financial statements. This recommendation is not

intended to replicate the external auditor's financial statement work but rather to obtain an incremental assurance for specific accounts as warranted.

Recommendations 4 - 6

OCC undertook several enforcement actions from 1992 up to Keystone's failure in 1999. These actions were largely ineffective in obtaining substantively full compliance with the articles of the enforcement actions. Reoccurring problems that were never fully addressed by Keystone included weaknesses in financial accounting, reporting and controls. In hindsight, these uncorrected problems proved key in masking the bank's true financial condition and, ultimately, the unsubstantiated loans.

In Chapter 3, the OIG also made several observations relative to OCC's enforcement response as to timeliness, the type of enforcement action used, and PCA's reclassification provision. Accordingly, the OIG recommends that the Comptroller of the Currency:

4. Enhance existing monitoring and review procedures of outstanding enforcement actions by establishing clearer guidelines on:

    - what constitutes full compliance versus progress towards full compliance before an action is either terminated, extended, or replaced with a more severe enforcement action.

    - the maximum time banks are allowed to achieve full compliance so as to avoid seemingly protracted periods when an enforcement action is extended as was done with the 1992/1993 Commitment Letter.

5. Reassess current enforcement practice that affords the use of concurrent informal enforcement actions for repeat violations as with the 1994 Supervisory Letter for the Call Report violations.

6. Reassess the use of PCA reclassification as a means of curbing uncontrolled growth without adequate controls versus incorporating this limitation in other enforcement actions.

Recommendation 7

The OIG acknowledges that timely enforcement action largely depends on the early detection of either unsafe/unsound financial condition and/or banking practices. Given the nature of periodic examinations as opposed to a continuous on-site presence, examiner detection of problems can occur after a bank has already established a high-risk position or accumulated a high level of risky assets.

Since 1992, OCC examiners found that Keystone was engaging in a strategy of high-risk growth without adequate fundamental management systems and controls. However, high profitability and capitalization appeared to mitigate OCC's supervisory response. This occurred even when Keystone was operating under an enforcement action up through 1996. During this four year period, Keystone's assets grew from $107 million period to $381 million, in effect a 300 percent increase.

Given the existence of the 1992 Commitment Letter, the OIG raises the issue as to whether a different supervisory response is needed when:

- high-risk growth is accompanied by high profitably and capitalization,
- fundamental management systems and controls are deficient, and
- management lacks expertise and its integrity is questionable.

Accordingly, the OIG recommends that the Comptroller of the Currency:

7. Further assess whether Keystone's failure necessitates a different supervisory response to mitigate the ultimate risk exposure to the BIF. The OIG believes this assessment needs to focus on high-risk growth while addressing known unsafe and unsound banking practices. This assessment should not be limited to regulatory restrictions on growth and incremental increases to regulatory capital. Other possible considerations might include the adequacy of existing regulations over the use of brokered deposits and certain interest rate restrictions, and possible restrictions on the use of insured deposits to fund uncontrolled high-risk growth. Furthermore, this assessment would likely necessitate consulting with other banking regulators through the Federal Financial Institutions Examination Council (FFIEC).

CHAPTER 4

Lessons Learned

As mentioned above, OCC has already started to implement a number of changes to improve its supervisory policies and procedures based on lessons learned through its experience with Keystone. Such changes include:

- providing guidance to examiners in securing access to bank books and records,
- increasing or improving oversight of asset securitization activities,
- starting an asset verification procedures database project,
- changing OCC guidance and practice for coordinating supervisory activities with FDIC, and
- establishing a quality assurance program for problem banks in OCC's Special Supervision and Fraud Division.

We believe that these changes will further enhance OCC's ability to effectively regulate the national banking system.

Guidance on Access to Bank Books and Records

OCC issued guidance to address situations when examiners encounter resistance by bank management to provide them with access to bank books and records. The Policies and Procedures Manual (PPM 5310-10), *Guidance to Examiners in Securing Access to Bank Books and Records*, dated January 7, 2000, discusses:

- OCC's statutory authority for access to bank information and records,
- bank management tactics sometimes used to resist examinations (referred to as "red flags"), and
- remedies that examiners have when they encounter resistance to requests to interview bank staff or review the bank's books and records.

OCC issued this guidance as a result of examiners at Keystone not having direct access to the bank's books and records.

Oversight of Asset Securitization Activities

OCC issued OCC Bulletin (OCC 99-46), *Interagency Guidance on Asset Securitization Activities*, dated December 14, 1999, to bank officers and examining personnel. The Bulletin reminds bank managers and examiners of the importance of fundamental risk management practices governing asset securitization activities. It discusses the expectation for critical components of an effective oversight program for asset securitization activities. These activities include:

- independent risk management commensurate with the complexity of securitization activities,
- comprehensive audit coverage,
- appropriate residual interest valuation and modeling methodologies,
- accurate and timely risk-based capital calculations, and
- prudent internal limits to control the amount of equity capital at risk that is used to support securitization retained interests.

Additionally, OCC in November 1999 asked its examiners to complete an asset securitization survey. The purpose of the survey was to determine the number of national banks involved in securitization activity and to assess the volume of risk from the booking of a residual asset.

Moreover, in December 1999, the OCC began setting up a special oversight committee, comprised of securitization experts who would help deal with banks that have gotten into or may get into trouble because of securitization activities.

This guidance was based on asset securitization activities found at Keystone and other banks.

Asset Verification Procedures Database

In November 1999, OCC established a project to develop a comprehensive database of verification procedures. The database is designed to provide examiners guidance on appropriate procedures to validate and test the bank's internal controls, and to verify the existence of assets and the reliability of financial records. The verification procedures should be issued in a new separate booklet of the Comptroller's Handbook or incorporated into individual booklets by subject area. OCC plans to complete this project in May 2000.

According to OCC, it is developing this database based on lessons learned from the Keystone review where direct verification was a means of identifying the bank's financial condition.

OCC and FDIC Coordination

OCC issued a draft memorandum dated January 5, 2000 that establishes guidelines to be followed in involving FDIC in OCC's examinations. Before Keystone's closure, the authority to deny an FDIC examination participation request was delegated to a division director. Now, only the Comptroller can deny an FDIC request to participate in an examination.

This memo was drafted in response to the situation in 1998 where the FDIC was initially denied participation in the on-site examination at Keystone. Although the FDIC was eventually allowed to participate in the Keystone examination, the OCC and FDIC felt that better communication was needed between the two agencies. Furthermore, senior OCC and FDIC officials have established monthly meetings to better communicate the status of problem banks.

Special Supervision Quality Assurance Proposal

In a draft memorandum, dated December 16, 1999, the OCC proposed to establish a Quality Assurance initiative for the Special Supervision and Fraud Division. The initiative will provide a written product addressing the effective and appropriate supervision of the banks and provide OCC management with a lessons learned study. A special review team will be appointed to assess a sample of Special Supervision banks. The team's primary objectives are to assess compliance with OCC's prompt corrective action policy and determine the effectiveness and appropriateness of supervision. The same team will assess those banks not covered by the OIG's material loss review. This program will help strengthen OCC's supervisory review of problem banks similar to Keystone.

Management Response and OIG Comments

In its March 8, 2000 written response to the OIG's draft report, OCC concurred with the reported findings, conclusions and recommendations. As noted above, OCC had already undertaken several initiatives based on lessons learned from Keystone. In response to our recommendations, OCC recently established a high level committee of senior deputy comptrollers to review, develop and implement corrective actions.

We believe OCC's planned actions are collectively responsive to the intent of the OIG's recommendations. The OIG will also continue to monitor OCC's progress in addressing the reported findings and recommendations. The full text of OCC's response is included in Appendix 1.

MANAGEMENT RESPONSE

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Dennis S. Schindel, Assistant Inspector General for Audit

From: John D. Hawke, Jr., Comptroller of the Currency

Date: March 8, 2000

Subject: Draft Audit Report on the Material Loss Review

We have received your draft audit report titled *Material Loss Review of The First National Bank of Keystone* and we believe it is a thoughtful and thorough analysis of the OCC's supervision of Keystone. We fully concur with the report's conclusions that the OCC has important lessons to learn from this matter. The supervisory issues you identified as being in need of particular attention include how we assess certain operational functions and safety and soundness issues, and how we use and obtain compliance with enforcement actions.

The report makes recommendations designed to improve the OCC's assessment of national banks' accounting, reporting and control functions and the related audits conducted by third parties. With respect to enforcement, you recommend that the OCC better define or clarify what constitutes compliance and that we reassess some of our current practices. Finally, you recommend that the OCC assess whether Keystone's failure points to the need for a different supervisory response so as to mitigate the ultimate risk exposure to the BIF.

These recommendations are constructive and we welcome them. As the report notes, the OCC has already undertaken a series of initiatives addressed to these concerns. I have recently formed a high level committee of senior deputy comptrollers to review your recommendations as well as our present management of problem banks, who will make recommendations to me as to how we can implement improvements in this area.

Our examiners were confronted with extraordinarily difficult circumstances in Keystone. While their perseverance ultimately led to the discoveries that resulted in the bank's closure, we should always review our performance in situations such as this to see how we can perform more effectively. We appreciate your awareness that the spectre of apparent fraud made it difficult to draw conclusions as to when the magnitude of the bank's losses could have been discovered, had different procedures been used. We will all benefit from the careful and thorough analysis that you have provided.

MANAGEMENT RESPONSE

Thank you for the opportunity to review and comment on the draft report. Our staff has provided technical comments directly to the I.G. Staff.

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GLOSSARY OF TERMS

Allowance for Loan and Lease Losses	A valuation reserve established and maintained by charges against a bank's operating income. As a valuation reserve, it is an estimate of uncollectable amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.
Asset Quality	The quantity of existing and potential credit risk associated with the loan and investment portfolio, other real estate owned, and other assets, as well as off-balance sheet transactions.
Brokered Deposits	Funds which a bank obtains, either directly or indirectly, by or through any broker, for deposit into a deposit account. Brokered deposits include both those in which the entire beneficial interest is held by a single depositor and those in which the deposit broker sells participations to one or more investors. Under 12 Code of Federal Regulations §337.6, only "well capitalized" banks may accept brokered deposits without FDIC approval.
Call Report	A bank's quarterly Consolidated Report of Condition and Income. It includes a balance sheet and income statement, and other information about the bank.
CAMEL/ CAMELS	The OCC and other bank regulators use the Uniform Financial Institution Rating System to evaluate a bank's performance. CAMEL is an acronym for the performance rating components: Capital adequacy, Asset quality, Management administration, Earnings and Liquidity. An additional component addressing Sensitivity to market risk was added effective 1/1/97. CAMELS
Capital Markets	Includes investments such as mortgage-backed securities, dealer activities, foreign exchange, off-balance sheet items and other related activities.

GLOSSARY OF TERMS

Cease & Desist Order	A formal enforcement action issued by the OCC to a bank or affiliated party to stop an unsafe and unsound practice or violation of a law or regulation pursuant to authority under 12 U.S.C. §1818. A Cease & Desist Order is terminated when the bank's condition has significantly improved and the bank has substantially complied with its terms.
Civil Money Penalty	A fine assessed against individuals or banks under 12 U.S.C. §1818 for violation of any law or regulation; any final or temporary order, including Cease & Desist Order, suspension, removal, or prohibition order; any condition imposed in writing in conjunction with the grant of any application or other request; any written agreement, and regulatory reporting requirements. Under certain circumstances, the OCC may also assess fines for unsafe or unsound practices and breaches of fiduciary duty.
Commitment Letter	An informal enforcement action comprised of a document signed by representatives of the OCC and the bank reflecting specific written commitments to take corrective action in response to problems or concerns identified by the OCC in its supervision of the bank.
Federal Financial Institutions Examination Council	A formal interagency body empowered to prescribe uniform principles, standards, and report forms for the Federal examination of banks by Federal regulators established under Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978.
FHA Title 1 Loan	Loans generally consisting of junior lien home improvement loans (a junior lien is one that is subordinate to a first lien).
Formal Agreement	A formal enforcement bilateral document signed by the board of directors and the responsible OCC official. Its provisions are set out in article-by-article form and prescribe those corrective and remedial measures necessary to correct deficiencies or violations in the bank and return it to a safe and sound condition. It is a legally recognized document issued pursuant to the OCC's enforcement authority under 12 U.S.C. §1818.

GLOSSARY OF TERMS

High Loan-to-Value	A loan secured by a lien on residential real estate where the lien may have less financial value than the amount of the loan. OCC considers a loan to be HLTV if the loan amount exceeds 90 percent of the appraised value of the real estate subject to the lien.
Informal and Formal Enforcement Actions	Informal enforcement actions are documents that provide a bank with guidance and direction in addition to that provided by the ROE. Informal actions are those instances where it is desirable to have written commitments from a bank's management and board of directors. Formal enforcement actions are reserved for significant safety and soundness or compliance problems that, unless corrected, constitute a present or future threat to the survival of the bank or otherwise pose a serious threat to the bank's safety and soundness.
Leveraged Borrower	A borrower whose debt to equity ratio is significantly above normal.
Loan Securitization	A way for banks to sell assets. In practice, banks securitize loans by pooling assets with similar characteristics and selling interests in these pools to investors. National banks currently are permitted to securitize residential, consumer and commercial loans.
OCC Ombudsman	Responsible for ensuring that the OCC appeals process provides a fair and timely review of disagreements on agency findings and decisions. With the consent of the Comptroller of the Currency, the Ombudsman has the discretion to supersede any agency decision or action during the resolution of an appealable matter.
Prompt Corrective Action	A framework of supervisory actions for insured banks which are not adequately capitalized. These actions become increasingly severe as a bank falls into lower capital categories. The capital categories are: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized (12 U.S.C. §1811).

GLOSSARY OF TERMS

Regulation Z, Truth in Lending	The Truth in Lending Act (15 U.S.C. §1601) was enacted in May 1968, and implemented as Regulation Z effective July 1969. The Act is intended to ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably.
Risk-Based Examinations	A bank examination strategy that focuses examiners on the identification, measurement, monitoring and control of risk.
Special Supervision and Fraud Division	Responsible for managing the closing of all national banks and for reviewing and coordinating the supervisory strategies of all banks which OCC believes to exhibit a high potential to fail within the next 12 months.
Subprime Mortgage	A mortgage loan to a borrower whose credit is below good credit standards. Such borrowers pose a greater risk and are characterized by paying debts late, filing for personnel bankruptcy and/or an insufficient credit history. A subprime loan is usually referred to as marginal, nonprime or below "A" quality.
Supervisory Letter	An informal enforcement action comprised of a document to be used in cases where a CMP is not warranted but the office nonetheless wishes to call attention to a supervisory problem pursuant to its authority under 12 U.S.C. §1818.
Temporary Cease and Desist Order	An interim order issued by the OCC pursuant to its authority under 12 U.S.C. §1818 and is used to impose measures that are needed immediately pending resolution of final Cease & Desist Order. Such orders are typically used only when immediately necessary to protect the bank against ongoing or expected harm. A TC&D may be challenged in U.S. District Court within 10 days of issuance, but is effective on issuance and remains effective unless overturned by the court or until a final order is in place.

GLOSSARY OF TERMS

Unsafe and Unsound Practice	A practice in which (1) there has been some conduct, whether act or omission, (2) which is contrary to accepted standards of prudent banking operations, and (3) which might result in exposure of the bank to abnormal risk or loss. An unsafe and unsound practice may be considered reckless if it evidences disregard of, or indifference to, the consequences of the practice, even though no harm may be intended.

CHRONOLOGY OF SIGNIFICANT EVENTS

The following chronology describes significant events in Keystone's history including: examinations conducted, major problems identified, and enforcement actions taken by OCC.

Date	Event
1904	Keystone is incorporated under the National Banking Act.
1977	Bank management changes hands.
1992	Keystone begins to purchase FHA Title I home improvement loans.
1/6/92	OCC conducts safety and soundness examination. Examiners identify system and internal control problems, weaknesses in the internal audit function, and Call Report violations; however, the overall condition of the bank remains satisfactory. CAMEL rating: 2/21312. Exam completed 2/14/92.[11]
3/19/92	Keystone signs Commitment Letter issued 3/7/92 to correct accounting system and internal control weaknesses.
7/12/93	OCC conducts safety and soundness examination. Examiners find that although the overall financial condition remains satisfactory, continued effort is needed to address internal control and audit problems identified in 1/6/92 exam. CAMEL rating: 2/21312. Exam completed 8/27/93.
10/28/93	Keystone signs revised Commitment Letter addressing FHA Title I loan securitizations.
4/11/94	OCC conducts safety and soundness examination. Examiners identify issues concerning gain on sale accounting, loan administration, and Call Report violations; compliance with Commitment Letter is in progress, but not complete. CAMEL rating: 2/22322. Exam completed 6/30/94.
4/28/94	Keystone's President writes to Senior Deputy Comptroller complaining of excessive OCC examinations.

[11] Exam completion date is the exit conference date with bank management.

CHRONOLOGY OF SIGNIFICANT EVENTS

7/8/94	FRB of Richmond, Virginia requests additional information from Keystone in order to process their initial draft application for the Employee Stock Ownership Plan as a bank holding company originally submitted 1/90.
9/8/94	OCC issues Supervisory Letter for Call Report violations identified in the 12/93 and 3/94 Call Reports.
5/5/95	OCC makes 2 criminal referrals to United States Attorney, Federal Bureau of Investigation, and United States Secret Service. One relates to falsification of bank records for Truth in Lending violations (Regulation Z). The other relates to the misapplication of bank funds for services that appear to have been performed as part of the President's official duties. [redacted]
5/8/95	OCC conducts safety and soundness examination. Examiners find reported earnings and capital satisfactory and compliance with the Commitment Letter is substantially complete; and accounting and control issues with the FHA Title I program are identified. CAMEL rating: 2/22322. Exam completed 8/3/95.
6/5/95	OCC conducts FHA Title I mortgage examination. Examiners identify several significant weaknesses in the administration of the FHA Title I mortgage banking operation. Composite rating downgraded from 2 to 3. Exam completed 12/1/95.
7/14/95	Keystone files application to establish operating subsidiary with OCC.
8/15/95	OCC approves application to establish an operating subsidiary to engage in mortgage banking service (Keystone Mortgage Corporation).
11/3/95	FDIC notifies OCC of composite rating downgrade from 2 to 3 based on numerous deficiencies noted in OCC's 5/8/95 examination. FDIC's CAMEL rating: 3/33433.
12/13/95	Keystone's President writes to OCC Ombudsman requesting an OCC examiner be fired for alleged disrespect to the President and the bank.

CHRONOLOGY OF SIGNIFICANT EVENTS

1/22/96	Keystone appeals to OCC Ombudsman contesting the composite rating downgrade. The downgrade from 2 to 3 is based on the 6/5/95 examination completed 12/1/95.
1/24/96	OCC terminates Commitment Letter based on 5/8/95 and 11/27/95 OCC examinations because Keystone was in substantial compliance with terms of the Commitment Letter.
2/15/96	FDIC asks to participate in next OCC examination to review FHA Title I program and related issues.
5/30/96	OCC's Ombudsman upholds OCC's composite rating downgrade from 2 to 3 based on the 6/5/95 examination.
6/5/96	OCC authorizes FDIC participation in 6/17/96 examination.
6/17/96	OCC conducts safety and soundness examination with FDIC participation. Examiners find Keystone management responsive to previous years deficiencies, but bank management still needs to establish sound controls over the bank information system. CAMEL rating: 2/22212. Exam completed 8/27/96.
1/1/97	Financial Accounting Standards Board No. 125 takes effect. It requires residual assets to be recorded in accordance with generally accepted accounting principles. Keystone did not book the residuals until September 1997.
6/10/97	Keystone files notice of intention to form a bank holding company with the FRB of Richmond, Virginia.
7/28/97	OCC conducts safety and soundness examination. Examiners identify concerns with controls over the loan portfolio of subprime home improvement loans, loans not being charged off, inaccurate bank reports, repeatedly unacceptable internal audit coverage, and Call Report violations. CAMELS rating: 3/344433. Exam completed 12/19/97.
9/4/97	Keystone's President requests a meeting with the OCC Comptroller.
9/9/97	Keystone's supervision is transferred from OCC Southeastern District to Special Supervision and Fraud Division in OCC Headquarters.

CHRONOLOGY OF SIGNIFICANT EVENTS

9/18/97	OCC internal document indicating that Keystone's application with the FRB of Richmond, Virginia to establish a holding company was going to be turned down.
10/26/97	Keystone's President dies.
2/13/98	FDIC requests to participate in next OCC examination tentatively scheduled for 11/2/98. FDIC notifies OCC of the composite rating downgrade from 3 to 4 based on serious weaknesses in asset quality, earnings and management depicted in OCC's 7/28/97 examination.
2/26/98	OCC sends letter to FDIC indicating participation in the next examination tentatively scheduled for 11/2/98 would be unnecessarily burdensome to the bank.
5/7/98	FDIC notifies Keystone of the composite rating downgrade from 3 to 4 based on serious weaknesses in asset quality, earnings, and management depicted in OCC's 7/28/97 examination.
5/28/98	Keystone signs Formal Agreement regarding the accuracy of the bank's accounting records and management information systems, the need to obtain a nationally recognized auditing firm, and 12 other articles requiring the bank to improve the safety and soundness of the bank.
6/26/98	Keystone hires a former OCC capital markets specialist as a bank consultant.
6/29/98	OCC notifies Keystone of their PCA "undercapitalized" category based on 3/31/98 Call Report.
7/27/98	OCC approves Keystone's selection of a nationally recognized Certified Public Accountant firm per the 5/28/98 Formal Agreement.
7/29/98	OCC authorizes FDIC to participate in the 8/31/98 examination originally scheduled for 11/2/98.
8/6/98	OCC notifies Keystone's legal counsel of intention to issue CMPs against the Senior Vice President and bank's Board of Directors for Call Report violations.

CHRONOLOGY OF SIGNIFICANT EVENTS

8/31/98	OCC conducts safety and soundness examination with FDIC participation. Examiners find a deficient residual valuation model, unsafe concentration of mortgage products, and violations of law (brokered deposits and Call Reports). ROE directs Board of Directors to replace current President, as duties and responsibilities were not commensurate with the position. CAMELS rating: 4/445444. Exam completed 1/12/99.
9/23/98	FDIC internal memorandum concludes that Keystone is subject to brokered deposit and interest rate restrictions.
11/9/98	OCC sends letter to Keystone providing initial opinion on proration of assets and risk-based capital.
12/4/98	Keystone appeals the proration of assets opinion to OCC's Ombudsman.
12/98	Keystone hires a former Comptroller of the Currency as a consultant.
12/21/98	OCC Comptroller receives letter from Senator John D. Rockefeller IV, West Virginia, expressing Keystone's concern with OCC's inconsistent application, interpretation, and clarification of policies and procedures.
12/22/98	OCC Comptroller receives letter from Senator Robert C. Byrd, West Virginia, requesting clarification from OCC with regard to certain policies, procedures, and regulations.
12/23/98	OCC Headquarters official has a phone conversation with the former Comptroller and current Keystone consultant discussing OCC's intent to write down residual value. The former Comptroller of the Currency requests that OCC hold off on making any adjustments to the residual value, but the OCC official does not agree.
2/1/99	OCC's Ombudsman allows Keystone to continue current practices on asset proration until FFIEC interagency agreement is finalized.
2/1/99	Former OCC capital markets specialist replaces interim Keystone President.
3/24/99	Former OCC capital markets specialist resigns as Keystone's President.

CHRONOLOGY OF SIGNIFICANT EVENTS

3/29/99	OCC & FDIC conduct one week on-site review of residual valuation, risk-based capital calculations, liquidity, and compliance with the brokered deposit regulations. OCC and FDIC also meet with external auditors to discuss the methodology for valuing the residual assets.
4/19/99	Keystone hires new President.
5/5/99	FFIEC issues interagency agreement on proration of assets, upholding OCC's 11/9/98 opinion.
6/15/99	OCC and FDIC examiners visit Certified Public Accountant's office to review audit workpapers for the 12/31/98 financial statement audit of the bank.
6/21/99	OCC starts safety and soundness examination with FDIC participation.
6/23/99	FDIC notifies OCC of composite rating downgrade from 4 to 5 based on OCC's 8/31/98 examination with FDIC participation. The FDIC noted the bank's viability could be in jeopardy unless record-keeping matters were resolved, a supported value of the residual was determined, concentration in HLTV loans was reduced, and management took proactive corrective action. FDIC's CAMELS rating: 5/455454.
7/5/99	OCC issues notice of CMP assessments.
7/19/99	6/21/99 examination is halted because the bank alleges a former OCC examiner made disparaging remarks against bank management. Consequently, Keystone obtains court order to hold OCC documents and workpapers.
7/23/99	OCC sends letter to Keystone requiring the bank to stop taping and monitoring OCC employees.
7/26/99	FDIC examiners find Keystone obtained $24 million of brokered deposits in violation of PCA brokered deposit restriction.
7/27/99	OCC examiners return to Keystone to resume 6/21/99 examination.
7/29/99	OCC asks permission from Keystone to contact the loan servicers to obtain direct verification of loan information.

CHRONOLOGY OF SIGNIFICANT EVENTS

8/18/99	Keystone brings in security guards reportedly to protect bank employees and examiners.
8/23/99	OCC examiners secure information from servicers indicating loan totals reported by Keystone are overstated by $515 million according to servicer provided reports.
8/23/99	OCC asks U.S. Marshals Service to provide security for OCC examiners during the 6/21/99 examination.
8/26/99	OCC's Washington Supervision Review Committee approves an Order of Investigation for apparent backdating of brokered deposit records. The Order also covered the misstatements of the bank's books and records, especially in connection with the bank's sale and booking of securitized loans.
8/27/99	OCC and FDIC examiners visit two servicers to confirm balances of loans held after finding a $515 million loan balance discrepancy on 8/23/99.
9/1/99	OCC declares Keystone insolvent and appoints FDIC as receiver.

DETAILED OBJECTIVES, SCOPE AND METHODOLOGY

We conducted this review of Keystone in response to our mandate under Section 38(k) of FDIA, 12 U.S.C. §1811. This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the inspector general for the appropriate Federal banking agency shall prepare a report to the banking agency, which shall:

- ascertain why the institution's problems resulted in a material loss to the insurance fund;
- review the agency's supervision of the institution; and
- make recommendations for preventing any such loss in the future.

As defined by Section 38(k) of FDIA, a loss occurring after June 30, 1997, is considered material if it exceed $25,000,000 or 2 percent of the institution's total assets. The Act also requires us to complete the report within six months after it becomes apparent a material loss has been incurred.

We initiated a material loss review based on the loss estimate prepared by the FDIC. As of December 31, 1999, the FDIC estimated that the Keystone failure will cost the BIF between $750 and $850 million.

Our review covered events spanning the last seven years of the bank's life from 1992 to 1999. We conducted fieldwork from September 1999 to January 2000.

We reviewed supervisory and enforcement files and records maintained by OCC's Headquarters in Washington, DC; District Office in Atlanta, GA; Field Office in Charleston, WV; and Ombudsman Office in Houston, TX.

We reviewed the quarterly Call Report data, Board of Directors' Minutes, and external audit reports for Keystone.

We interviewed FDIC Investigators to obtain their overall conclusions on why the bank's failure resulted in a material loss to the BIF.

DETAILED OBJECTIVES, SCOPE AND METHODOLOGY

To assess the adequacy of OCC's supervision of the bank, we attempted to determine (1) when OCC first identified Keystone's safety and soundness problems, (2) the gravity of the problems, and (3) the action OCC took to get the bank to correct the problems. Additionally, we attempted to determine whether (1) the problems could have been discovered earlier, (2) all the problems were identified and reported, and (3) enforcement actions were comprehensive, timely, and effective in dealing with the unsafe or unsound activity. Specifically, we:

- Assessed OCC actions based on its own internal guidance and legislative guidance provided by Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and FDIA.

- Discussed various aspects of the supervision of Keystone with knowledgeable senior OCC officials.

- Reviewed 1992 through 1999 examination reports and related available examination documents and workpapers relative to Keystone. We began our review of examination reports with the 1992 examination because OCC issued a Commitment Letter in 1992. In reviewing examination reports, we sought to obtain information on the condition of the bank at the time of each examination and the significance of the bank's problems identified by the OCC. However, we were unable to fully assess OCC's basis for the revised 1995 examination rating. This audit limitation occurred because OCC's workpapers for the June 5, 1995 examination were lost in 1995.

- Reviewed 1992 through 1999 correspondence and enforcement files to gain an understanding of the problems identified, the approach and methodology used by OCC to assess the bank's condition, and the regulatory action used by OCC to compel the bank management to address the deficient conditions found.

- Reviewed and analyzed OCC's Supervisory Monitoring System data, and reports including: Supervisory Events, Other Significant Events, Overall Summary Comments, and Risk Assessments.

DETAILED OBJECTIVES, SCOPE AND METHODOLOGY

- Interviewed OCC officials from the Special Supervision and Fraud Division and Enforcement and Compliance Division in OCC's Headquarters, and officials from the Southeastern District.

- Interviewed the OCC EICs for all examinations since 1992 to obtain their perspective on the bank's condition and the scope of the examinations. We also interviewed at least one other examiner from each examination, including capital markets and securitization specialists who participated in the Keystone examinations.

- Reviewed selected FDIC supervisory files including correspondence with OCC and Keystone, and interviewed at least one FDIC examiner from each of the examinations in 1996, 1998 and 1999.

To prevent the inappropriate disclosure of sensitive information, we provided the FDIC a copy of the draft report. Their comments have been incorporated into this report, where appropriate.

We conducted this audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and included such tests as were deemed necessary. At the time of review, Federal law enforcement officials were still investigating alleged fraud at Keystone. FDIC's investigative activities had also not been completed in sufficient time for us to take into account in our review. Consequently, we did not attempt to fully determine the cause of the bank's failure beyond readily available records at the time.

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